



STATE BOARD OF EQUALIZATION STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	02/13/04	Bill No:	AB 1998
Tax:	Sales and Use	Author:	Dutton
Board Position:		Related Bills:	AB 2070 (Houston) AB 2991 (Runner) SB 1295 (Morrow) SB 1554 (Karnette)

BILL SUMMARY

This bill would reinstate the partial state sales and use tax exemption for purchases of qualifying equipment by new manufacturers, and would broaden that exemption to include power generation equipment purchased by new establishments engaged in the generation, transmission and distribution of electricity.

ANALYSIS

Current Law

Under existing law, a sales tax is imposed on retailers for the privilege of selling tangible personal property in this state. The use tax is imposed on the storage, use, or other consumption in this state of tangible personal property purchased. Either the sales tax or the use tax applies with respect to all sales or purchases of tangible personal property, unless that property is specifically exempted.

Until January 1, 2004, Section 6377 of the Sales and Use Tax Law provided a 5 percent state sales and use tax exemption for purchases of manufacturing equipment. Under that statute, the partial exemption was available only to “qualified persons,” who included only new trades or businesses that are engaged in those lines of business described in Standard Industrial Codes 2011 to 3999 (manufacturers). The partial exemption applied to the following:

- Tangible personal property to be used 50 percent or more in any stage of manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment belts, shafts, computers, software, pollution control equipment, buildings and foundations).
- Tangible personal property purchased for use in research and development.
- Tangible personal property purchased by a contractor or a subcontractor for use in a construction contract for a manufacturer for use in manufacturing, processing, refining, fabricating, recycling, or as a research or storage facility.
- Tangible personal property purchased to be used 50 percent or more in maintaining, repairing, measuring, or testing any exempt manufacturing equipment.

This exemption statute contained a sunset provision based on the number of manufacturing jobs in California. Under that provision, if the number of non-aerospace manufacturing jobs in California had not increased by at least 100,000 above the comparable 1994 number, the exemption would expire. Each year, the Employment

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Development Department was required to determine the number of non-aerospace manufacturing jobs, and if the number ever fell below 100,000, the exemption would expire on the next January 1.

Under the Personal Income Tax Law and the Corporation Tax Law, a 6 percent income tax credit on similar property was available to businesses who either did not qualify as a new trade or business under Section 6377, or who would have qualified as a new business, but decided to claim the 6% credit rather than the 5% exemption. A similar sunset clause was contained in these laws as well.

Proposed Law

This bill would reinstate the manufacturers' exemption contained in Section 6377 of the Sales and Use Tax Law and, in addition, include within that partial exemption, the sale or purchase of power generation equipment for use by a qualified person in those lines of business described in Standard Industrial Code (SIC) 4911 (electric power generation, transmission, and distribution). The exemption would be at the 5.25% state rate.

The bill would also amend the Personal Income Tax Law and Corporation Tax Law to reinstate the manufacturers' income tax credit and broaden that credit to include electric power generators and certain computer services providers.

The bill would become effective immediately, but the provisions of the exemption would apply to purchases made on or after January 1, 2005.

Background

The manufacturer's sales and use tax partial exemption for new manufacturers and the corresponding income tax credit for existing manufacturers were added in 1994 by SB 671 (Stats. 1993, Ch. 881). The purpose of that legislation was to enable California to become competitive with the 42 other states that exempted manufacturing equipment and were luring manufacturers away from California with promises of lower taxes. SB 671 was designed to provide California companies with an immediate incentive to expand their facilities and to create new jobs.

According to the Employment Development Department (EDD), by January 1, 1998, manufacturing employment had increased by over 213,000 more than in 1994. However, by January 1, 2003, that employment figured dropped below the 100,000 benchmark, and the statute was repealed by its own terms effective January 1, 2004.

In an October 2002 report put out by the Legislative Analyst's Office, *An Overview of California's Manufacturers' Investment Credit*, the following arguments in support of and against these tax incentives were presented:

Arguments Supporting the MIC

- **Investment Incentive**—The MIC effectively reduces the price of new capital, and leads to greater investment. Adherents of this view suggest that a firm considering a capital investment is much more likely to undertake such investment with the MIC in place. Proponents argue that this marginal cost reduction can have a significant positive impact on investment decisions.
- **Relocation Incentive**—California has become a more attractive place relative to other states for business since the credit has been in place. The argument here is that tax credits do influence corporate location decisions and dissuade businesses

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from moving their activities out of California. Manufacturing industry representatives stated and continue to state that the MIC plays an important role in both expansion and business location decisions.

- **Efficient Job Allocator**—Competition for business among states is an efficient job allocator. This argument holds that the nation benefits from the redistribution of jobs that may occur due to the use of investment tax credits. This is based on the notion that jobs are worth more in areas with higher unemployment, and that such areas are likely to have relatively aggressive tax credit programs. These areas will be able to attract businesses away from regions that do not value the jobs as highly.
- **Other Arguments.** Advocates of the MIC also emphasize that the MIC offers significant indirect benefits to the state in terms of investment and job growth that result in additional state revenues. They also point out the importance of manufacturing to the overall state economy in terms of economic stability and the high value-added nature of the employment in this sector.

Arguments Against the MIC

- **Inequitable Taxation**—The MIC results in giving a tax advantage to manufacturing over other business activities, as well as providing an advantage to capital investment over labor. This view holds that since only one type of industry (and production factor) benefits from the tax credit, the remaining industries face relatively higher costs, and are therefore at a competitive disadvantage. Such preferential treatment can also result in inefficient resource allocation according to this view.
- **Relocation Rather Than Creation**—The MIC results in few new jobs, but rather pits states against each other in competing for jobs. The argument here is that corporate tax breaks are no more than a transfer of government funds to private businesses, and in the end, the national economy is unaffected. In this view the competition among states in offering various tax incentives represents a form of “prisoners’ dilemma”—in which each state would be better off if none offered such incentives. If one state does offer them, however, it is in the interest of other states to do the same.
- **Inefficient Development Policy**—Tax incentives have a negligible impact on economic growth, and any job creation that does occur does so at a substantial cost per job. Proponents of this view also hold that some of the tax credits will go to companies which would have made the same investments, regardless of the tax incentive. That is, the tax credit did not induce the investment, yet the company receives “windfall benefits” in the form of reduced taxes.
- **Ineffective Development Policy**—Taxes are a very small percentage of overall business costs and thus have little effect on business decisions. Labor, transportation, land, and other factors typically constitute much more significant proportions of total costs than do taxes. Therefore, according to those who hold this view, tinkering with this particular cost is unlikely to result in a large shift or expansion of business compared to the adverse fiscal effects that such measures can have on the state.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the author. According to the author's office, the purpose of the bill is to continue the incentives provided to California manufacturers and increase the incentive for the production of electricity in California.
2. **The state sales and use tax rate will be 5.25% effective July 1, 2004.** The original exemption began in 1993 at the 6% rate and was reduced to 5% one year later to eliminate from the exemption the state tax portion of the sales and use tax rate, local revenues deposited into the Local Revenue Fund and the Local Public Safety Fund. With the passage of AB 9 (Ch. 2, 2003-04 Fifth Extraordinary Session), and ACA 5 (Res. Ch. 1, 2003-04 Fifth Extraordinary Session) and adoption of the Economic Recovery Bond Act approved by the voters at the March 2, 2004 statewide primary election, the state sales and use tax rate increases to 5.25%. Thus, enactment of this measure would result in a 5.25% state sales and use tax exemption for qualified purchases (local revenues would not be affected).
3. **How far should the current exemption for manufacturers be extended?** Since the original manufacturers' exemption was created in 1993, there have been a variety of measures before the Legislature to broaden that exemption to other segments of industry, such as agricultural, biopharmaceutical, teleproduction activities, as well as power generation, as this measure would do. Admittedly, there are numerous borderline activities between manufacturing and other divisions of the classification system. There are some manufacturing-type activities performed by establishments, such as manufacture of software, electricity, and a variety of other activities that are covered in other divisions under the current classification system and consequently, do not fall within the current language of the exemption. Should all these borderline industries be included?
4. **Related legislation.** As of the date of this analysis, four other bills have been introduced this session to reinstate this exemption. These include AB 2070 (Houston), which would restore the partial sales and use tax exemption and income tax credit; AB 2991 (Runner), which would simply restore the partial sales and use tax exemption effective January 1, 2004; SB 1295 (Morrow), which would restore the partial exemption and the income tax credit effective January 1, 2004 and would increase the income tax credit from 6% to 8%; and SB 1554 (Karnette), which would restore both the partial sales and use tax exemption as well as the income tax credit.

COST ESTIMATE

Enactment of this measure would result in administrative costs attributable to notifying affected retailers and reviewing and approving claimed exemptions. An estimate of these costs is pending, but they are expected to be minor (between \$10,000 and \$50,000)

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REVENUE ESTIMATE

Current purchases of qualified equipment as defined in this proposal are represented in the table as total expenditures by SIC code.

SIC Codes	Classification	Equipment Expenditures
2011 to 3999	Manufacturing	\$ 137.4 million
4911	Electricity Generation	\$ 33.0 million
Total		\$ 170.4 million

Revenue Summary

The annual revenue loss from exempting \$170.4 million in equipment expenditures purchased by qualified persons effective January 1, 2005 is estimated to be the following:

	Total Purchases (12 mos.)	Revenue Loss
State (5.250%)	\$170.4 million	\$ 8.95 million

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